In Plain English:

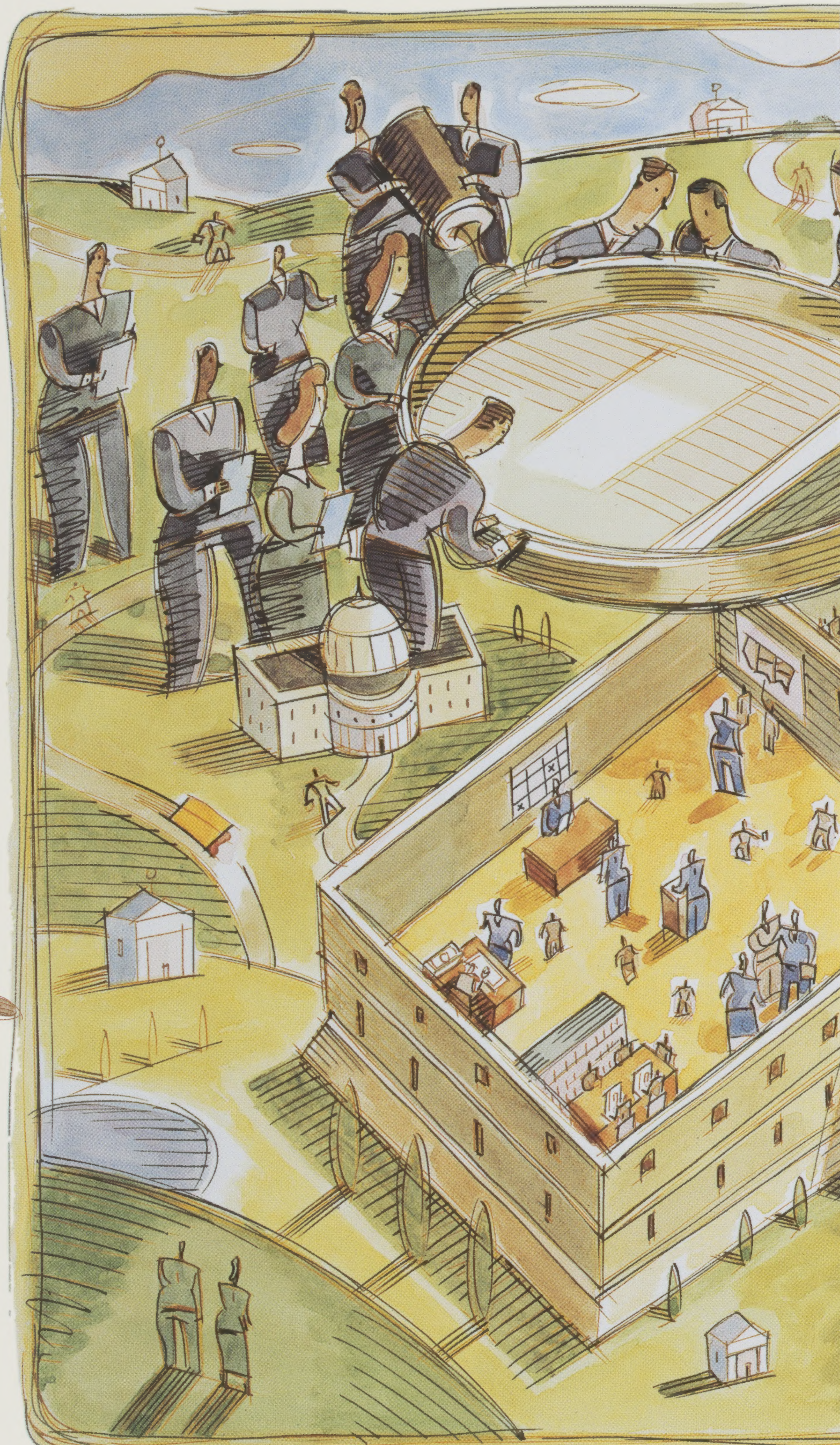
MAKING SENSE OF THE FEDERAL RESERVE

[THE FEDERAL RESERVE BANK OF ST. LOUIS]

Wow!

We weren't kidding; there's a lot happening on this page! Truth is, there's a lot going on in the Federal Reserve System. But keep in mind that the whole is really just the sum of its parts.

Basically, the Federal Reserve (or as most people call it, the Fed), consists of three parts: the Board of Governors (building at left), Reserve Banks (12 buildings at right) and the Federal Open Market Committee (meeting room inside the Board of Governors). Congress and the White House are here, too, but we'll touch on their roles later.




Chicago
Boston
Minneapolis
Cleveland
Tours
New York
San Francisco
Dallas
Philadelphia
Kansas City
Use Direct Deposit
To FOMC
Richmond
St. Louis
Courier
Board of Governors
Checks
Atlanta
Security

Warning!

The illustration you are about to uncover may overwhelm you at first glance, but trust us. We'll make sense of it together and discover not only who makes up the Federal Reserve, but also the varied things we do. Stick with us, and by the time we end this tour, you too will be able to explain the Federal Reserve in plain English.

First Things First

WHY A FEDERAL RESERVE SYSTEM?

In Plain English:

The Federal Reserve was created in 1913 in response to the nation's recurring banking panics; its mission has since expanded into fostering a healthy economy.

Before we dig into the Fed's structure and how it works, let's start with some background on the Federal Reserve—how and why we were created in the first place.

Just prior to the founding of the Federal Reserve, the nation was plagued with financial crises. At times, these crises led to "panics" in which people raced to their banks to withdraw their deposits. A particularly severe panic in 1907 resulted in bank runs that wreaked havoc on the fragile banking system and ultimately led Congress in 1913 to write the Federal Reserve Act. Initially created to address these banking panics, the Federal Reserve is now charged with a number of broader responsibilities, including fostering a sound banking system and a healthy economy.

Establishing the nation's first central bank was no simple task. Although the need for a central bank was generally undisputed, for decades early supporters debated the delicate balance between national and regional interests. On a national front, the central bank had to be structured to facilitate the exchange of payments among regions and to strengthen the U.S. standing in the world economy. On a regional front, it had to be responsive to local liquidity needs, which could vary across regions.

Another critical balancing act was that between the private interests of banks and the centralized responsibility of government. What emerged with the Federal Reserve System was a central bank under public control, with countless checks and balances.

As our diagram illustrates, Congress oversees the entire Federal Reserve System. And the Fed must work within the objectives established by Congress. Yet, Congress gave the Federal Reserve the autonomy to carry out its responsibilities insulated from political pressure. Each of the Fed's three parts —the Board of Governors, the regional Reserve Banks and the Federal Open Market Committee—operates cooperatively, yet independent of the federal government, to carry out the Fed's core responsibilities.

Now let's break down the structure and responsibilities on the following pages—a kind of who we are and then what we do.

[THE FEDERAL RESERVE BANK OF ST. LOUIS]

Who We Are

FEDERAL RESERVE BANKS

In Plain English:

Reserve Banks conduct research on the economy, supervise banks in their regions and provide financial services to banks and the U.S. government.

Visit a Federal Reserve Bank, and you'll see that its operations resemble the flurry of activities that go on in private business.

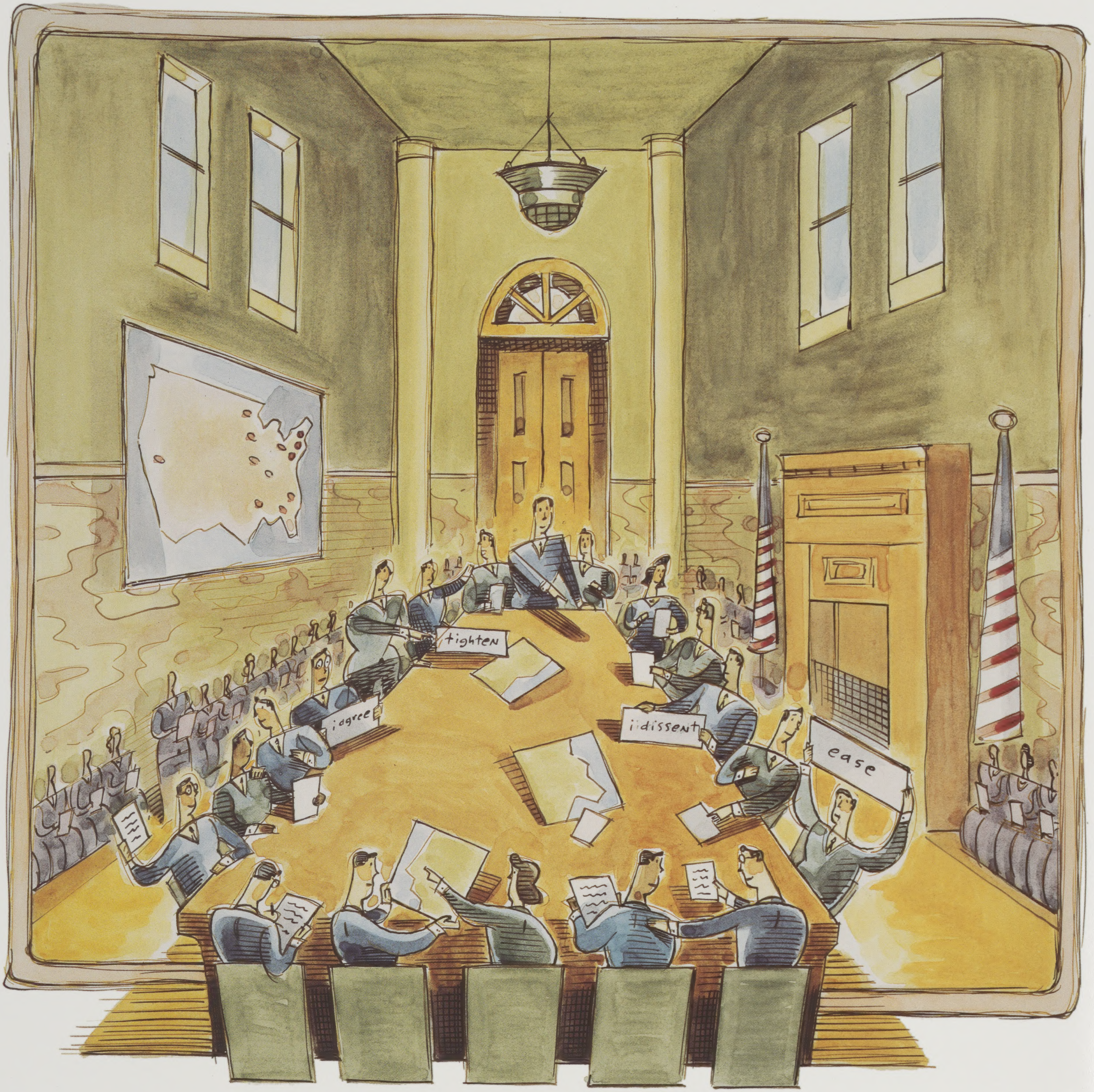
Reserve Banks are the *decentralized* components of the Fed's structure, meaning that they operate somewhat independently, but under the general oversight of the Board of Governors. Reserve Banks make valuable contributions to policy discussions, providing a regional banking perspective and the expertise of their local economies. This decentralized structure is a good example of the Federal Reserve's complex, yet effective, design.

The Federal Reserve System is divided into 12 districts. Each district is served by a regional Reserve Bank, most of which have one or more branches (see pages 8 and 9).

Reserve Bank activities serve primarily three audiences—bankers, the U.S. Treasury and the public. Reserve Banks are often called the "bankers' bank," storing banks' excess currency and coins, and processing and settling their checks and electronic payments. Reserve Banks also supervise commercial banks in their regions.

As a bank for the U.S. government, Reserve Banks process the Treasury's payments, sell its securities and assist with its cash management and investment activities. Finally, Reserve Banks conduct research on the national and regional economies, prepare Reserve Bank presidents for their participation on the FOMC, and disseminate information about the economy through publications, speeches, educational workshops and web sites.

Each Reserve Bank has its own board of directors that oversees the activities of the organization. These directors contribute local business experience, community involvement and leadership, and reflect the diverse interests of each District. The board of directors has nine members: six, including the chairman and deputy chairman, serve as representatives of the public; three serve as representatives of banking. (Reserve Bank branch offices have smaller boards of directors.) The board imparts a private-like management perspective to the Reserve Bank that emphasizes efficiency and quality. The board also appoints the president of the Reserve Bank, with the approval of the Board of Governors.



[THE FEDERAL RESERVE BANK OF ST. LOUIS]

Who We Are

FEDERAL OPEN MARKET COMMITTEE

In Plain English:

The FOMC manages the nation's money supply to help the economy achieve sustainable growth.

The Federal Open Market Committee, or FOMC, is the Fed's chief monetary policymaking body. Simply put, when we say that the Fed conducts monetary policy, we are talking specifically about the FOMC's role in managing the nation's money supply. Hang in there, we'll explain.

The FOMC typically meets eight times a year in Washington, D.C. At each meeting, the committee discusses the outlook for the U.S. economy and the best way to promote the economy's sustainable growth. The committee then discusses how the Fed will use its various policy tools to put that policy into place. Finally, it issues a directive, which drives one of three outcomes —easing, tightening or maintaining the growth of the nation's money supply, whichever is conducive to fostering a healthy economy at that time.

The FOMC uses three tools to influence the growth of the money supply: 1) the discount rate, which is the rate that the Fed charges banks that borrow from it; 2) reserve requirements, which is the percentage of deposits that banks must hold "on reserve" with the Fed; and 3) open market operations, which is the buying and selling of Treasury securities on the open market. By far, the most frequently used tool is open market operations. (You'll hear more about this tool later.) All three tools influence the amount of money that banks have available to lend.

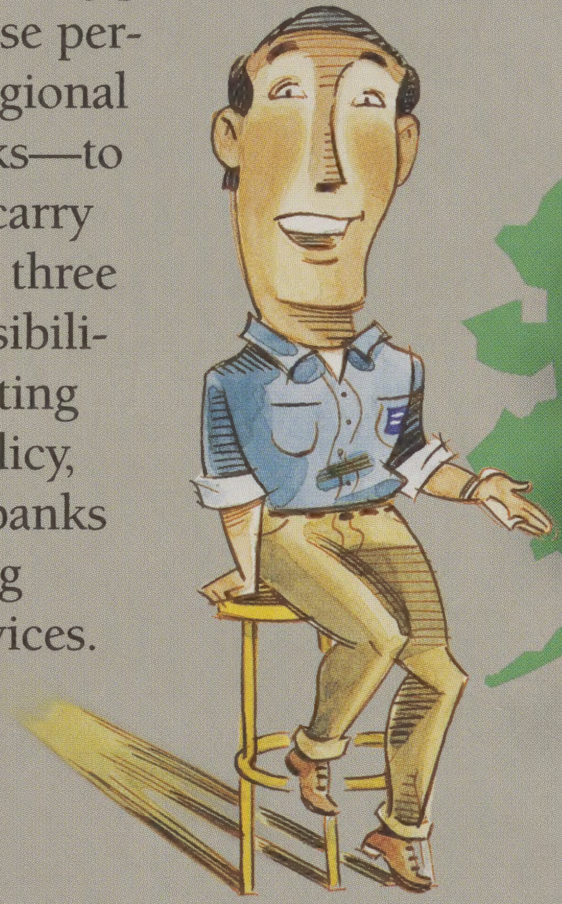
Interestingly, the news media often portray the FOMC—or more generally, the Fed—as the organization that raises or lowers interest rates. But in truth the FOMC controls only one rate directly: the discount rate mentioned above. The FOMC does *influence* other rates by its actions—in fact, the committee at times sets target ranges for other interest rates. But the Fed does not set most interest rates; market forces do.

The FOMC has 19 members, 12 of whom are voting members: the seven members of the Board of Governors, the president of the Federal Reserve Bank of New York, and four other Reserve Bank presidents, who serve one-year terms on a rotating basis. At every meeting, however, all 12 Reserve Bank presidents participate in FOMC policy discussions, whether or not they are voting members.

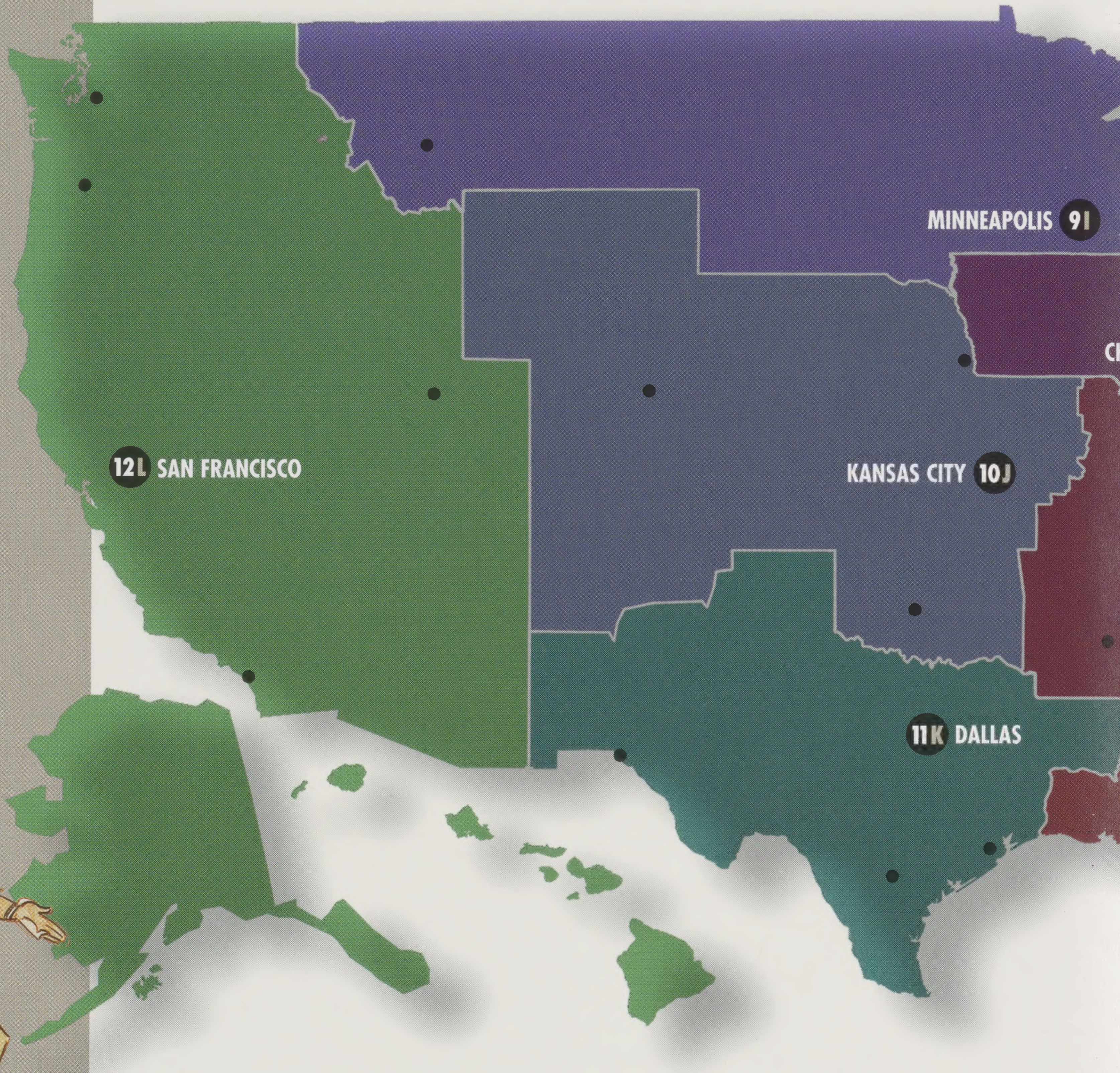
Still with us?

Great, you're halfway through! Now that you know who we are at the Federal Reserve—1) the Board of Governors as the federal government agency; 2) the Reserve Banks as the operational arms; and 3) the FOMC, the committee that sets monetary policy—let's move on to the "what we do" portion. (Is our main fold-out illustration starting to make sense yet?)

In the second half of this booklet, we'll walk through the activities of the Federal Reserve—looking primarily at those performed by regional Reserve Banks—to see how we carry out the Fed's three main responsibilities: conducting monetary policy, supervising banks and providing financial services.



The Federal Reserve System's centralized component, the Board of Governors, is located in Washington, D.C. (see star on map). Its decentralized components, Reserve Banks, are scattered throughout the country. Listed at the bottom of the page are the 12 Reserve Banks and their branches.



TWELVE RESERVE BANKS AND THEIR BRANCHES

1 BOSTON	2 NEW YORK	3 PHILADELPHIA	4 CLEVELAND	5 RICHMON
	Buffalo		Cincinnati	Baltimor
			Pittsburgh	Charlott

The Big Picture

THE FED'S REGIONAL STRUCTURE

The map at left highlights the 12 Reserve Banks and their 25 branch locations. Note that each Bank is identified with a corresponding letter and number. We use this coding to identify Federal Reserve districts. The Treasury uses it as well. Take a look at any U.S. bill—it features the letter and number of the Fed district that first places that bill into circulation.

Reserve Banks are the decentralized components that carry out the Fed's policies at a regional level. It is here that the laws written by Congress, and the regulatory policies written by the Board of Governors, are executed on a day-to-day basis. What is also critical is the role they play in bringing local economic perspectives to the national arena.

For example, an economist at a Reserve Bank may learn of the anticipated expansion or shutdown of a major local employer. Such news will obviously affect the local economic outlook, but will it have an impact on the national economy? The economist's local proximity and expertise can help policymakers who participate in FOMC discussions evaluate whether regional pockets of economic data skew the national picture, or reflect it.

Also, because Reserve Banks interact directly with local bankers—examining their books and offering financial services—they are knowledgeable about the effects of national policies on local bankers, and can funnel that information to the Board of Governors.

The Reserve Banks do much more than just add regional perspectives, though. In fact, this decentralized structure, allowing for independent perspectives, actually helps the Federal Reserve do its job most effectively. The synergy created by the ongoing exchange of ideas allows the Federal Reserve to be both better policymakers and implementors.

Now, back to the tour, and on to "what we do."

6 ATLANTA	7 CHICAGO	8 ST. LOUIS	9 MINNEAPOLIS	10 KANSAS CITY	11 DALLAS	12 SAN FRANCISCO
Birmingham	Detroit	Little Rock	Helena	Denver	El Paso	Los Angeles
Jacksonville		Louisville		Oklahoma City	Houston	Portland
Miami		Memphis		Omaha	San Antonio	Salt Lake City
Nashville						Seattle
New Orleans						

What We Do

CONDUCTING MONETARY POLICY

In Plain English:

The Federal Reserve manages the nation's money supply to keep inflation low and the economy healthy.

One of the most important jobs of the Federal Reserve is to keep our economy healthy. It does this by managing the nation's system of money and credit, or conducting monetary policy.

Experience has shown us that the economy performs well when inflation is low. Indeed, in countries as far flung as New Zealand, Canada and the United Kingdom, central banks are increasingly being held responsible for setting a low target for inflation and then hitting it. Why? Because when inflation is low—and is expected to remain low—interest rates are usually low as well. Such an environment will foster low unemployment and allow the economy to achieve its growth potential. Free from the disruptive effects of high and variable inflation, consumers and producers make economic decisions with confidence and wisdom.

A FORWARD-LOOKING APPROACH

The ability to maintain a low inflation rate is a long-term measure of the Federal Reserve's success in monetary policy. To achieve this success, the Fed uses a variety of intermediate targets, including monetary aggregates, reserve aggregates and interest rates, to gauge the impact of its policies on the nation's economy. The actions that the Fed take today influence the economy and the inflation rate for some time to come. Consequently, policymakers must be forward-looking and must take preemptive action to head off inflation before it gathers momentum.

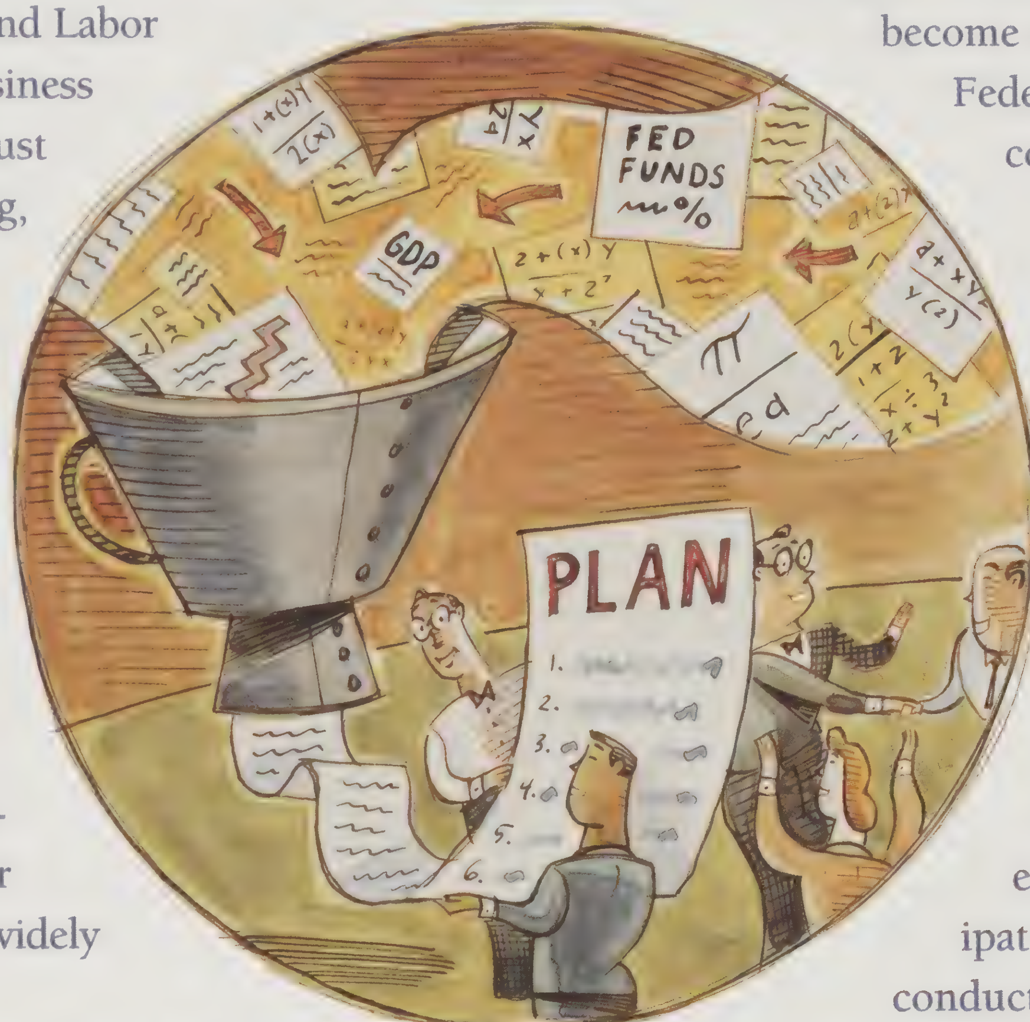
We learned earlier in this booklet that the FOMC establishes the goals of monetary policy. But the 12 Reserve Banks play critical roles, too. After each meeting, the FOMC issues a directive to the Open Market Desk at the New York Fed. This directive sets out some general objectives that the FOMC wishes the Open Market Desk to achieve—easing, tightening or maintaining the growth of the nation's money supply. To achieve these goals, the Open Market Desk each day buys or sells Treasury securities in the open market.

While policy deliberations of the FOMC are conducted in private, the Fed has always made its decisions known to the public. Beginning in 1994, the FOMC began announcing its policy decisions *immediately* after making them.

THE RESERVE BANKS' ROLE

Research economists at all 12 Reserve Banks, as well as economists at the Board of Governors, contribute to the policymaking process. Generally speaking, research economists at Reserve Banks are monitoring the unique economies of their districts and studying relationships among national economic indicators. Their primary duty is to prepare their Reserve Bank president for his or her participation in FOMC deliberations.

The research staff do three things: gather, analyze and disseminate information about the economy. They gather data from numerous sources: financial institutions; government institutions like the Commerce and Labor departments; and local business and community leaders. Just before each FOMC meeting, for example, researchers survey key industry contacts and assemble a report called *The Beige Book*, which can often spot meaningful trends in economic activity before they show up in national statistics. *The Beige Book* serves as an up-to-the-minute backdrop for FOMC discussions and is widely reported on in the press.



The loan and deposit data that Reserve Banks collect from banks and bank holding companies are perhaps the most critical statistics the Fed gathers. Such information is used in analyzing regional and national bank performance, credit demand and other banking topics.

Figuring out what to make of all this information is the hard part, of course. The task of analyzing the wide range of economic data falls generally onto the laps of Reserve Bank economists, who advise the Reserve Bank president, write articles for publication and prepare papers for professional conferences, all the while looking for the key pieces of evidence that will contribute to better monetary policy. Research agendas vary from Reserve Bank to Reserve Bank, which fosters a diversity of viewpoints within the Federal Reserve System. Reserve Banks can often have a broad influence on economic thought. Some research departments have become well known outside of the Federal Reserve System for their contributions.

SPREADING THE WORD

The Federal Reserve shares the viewpoints that emerge from its research. In addition to producing educational publications for audiences of all stripes, Fed speakers address numerous groups on the economic outlook, participate in professional forums, conduct educational seminars for area teachers, provide economic backgrounders for local reporters, give tours of Federal Reserve Banks and lend videos about the economy to classrooms. Web sites at each Reserve Bank and the Board of Governors broaden the reach of the Federal Reserve's economic expertise.

What We Do

SUPERVISING AND REGULATING BANKS

In Plain English:

The Federal Reserve writes regulations and supervises banks to ensure that the banking system is safe, sound and able to respond to a financial crisis.

When creating the Federal Reserve, one of Congress' paramount concerns was to address the nation's banking panics. This short-term need led to one of the Fed's three main responsibilities: to foster safe, sound and competitive practices in the nation's banking system.

To accomplish this, Congress gave the Fed responsibility to regulate the banking system and supervise certain types of financial institutions. What's the difference between these two? Bank *regulation* refers to the written rules that define what acceptable behavior is for financial institutions. The Board of Governors carries out this responsibility. Bank *supervision* refers to the enforcement of these rules. The 12 Reserve Banks carry out this responsibility, supervising state-chartered member banks, the companies that own banks (bank holding companies) and international organizations that do banking business in the United States. The FDIC and the OCC also supervise banks.

For the Fed, supervising banks generally means one of three duties: establishing safe and sound banking practices; protecting consumers in financial transactions; and ensuring the stability of U.S. financial markets by acting as lender of last resort. The common goal of all three duties, however, is the same: to minimize risk in the banking system.

SAFETY AND SOUNDNESS

The banking system is only as safe and sound as the banks within the system. So the Federal Reserve examines banks regularly, with the focus primarily on identifying and containing bank risk.

In the past, Reserve Bank examiners reviewed each bank in much the same manner—looking over the bank's books on-site and evaluating the quality of its assets and its ability to cover loan losses adequately. Today, Fed examinations are more customized, taking into account that banks differ markedly in their services and products, and that a bank's own management should be held responsible for monitoring the institution's exposure to risk. By looking at the bank's risk management procedures and internal controls, Reserve Bank examiners assess whether a bank's ability to manage risk matches the level of risk it assumes. Examiners also review a bank's performance in complying with its

own internal policies, as well as federal and state laws and regulations.

At the end of an on-site review, Fed examiners issue the bank a rating that reflects the institution's condition. The rating indicates whether the institution is sound enough to withstand fluctuations in the economy or whether it exhibits weaknesses that require corrective action and close monitoring. Between examinations, Reserve Banks monitor financial institutions by examining reports filed with the Fed.

Another way the Federal Reserve helps keep the banking system safe and sound is by reviewing major changes in a bank's structure or service offerings. When a bank wishes to expand, merge with another bank, acquire another bank or introduce new products, it must first get permission from the Federal Reserve. Reserve Banks strive to achieve two objectives when evaluating any application: to ensure that the resulting organization or product will be safe and sound and that competition will remain in the regional banking market.

CONSUMER PROTECTION

Another Fed goal is to protect consumers in lending and deposit transactions. Congress has given the Fed broad power to make, interpret and enforce laws that protect consumers from lending discrimination and inaccurate disclosure of credit costs or interest rates. Fed examiners specially trained in consumer compliance laws examine banks for their adherence to such regulations.

In their Community Affairs departments, Federal Reserve Banks also take an active role in helping institutions broaden access to capital and credit by hosting forums and bringing together lenders, government agencies and community development groups.

LENDER OF LAST RESORT

Perhaps the most important supervisory responsibility of all, however, is to respond to a financial crisis by acting as lender of last resort for the nation's banking system. Through its "discount window," the Fed lends money to banks so that a shortage of funds at one institution does not disrupt the flow of money and credit in the entire banking system. Typically, the Fed makes loans to satisfy a bank's unanticipated needs for short-term funds. But the Fed also makes longer-term loans to help banks manage seasonal fluctuations in their customers' deposit or credit demands. Agricultural banks, whose customers need funds for spring planting and can repay these funds after the fall harvest, often take advantage of the Fed's seasonal borrowing program.

What We Do

PROVIDING PAYMENTS SERVICES

> **In Plain English:**
>
> The Federal Reserve offers financial services to banks and the U.S. government to foster competition, innovation and efficiency in the marketplace.

When Congress established the Federal Reserve, it charged the Fed with the critical task of providing a safe and efficient method of transferring funds throughout the banking system. Reserve Banks and their branches carry out this mission, offering payments services to all financial institutions in the United States, regardless of size or location. Hand in hand with that mission is the obligation to improve the payments system by encouraging efficiency and technological advances.

Essentially, a Reserve Bank serves as a bankers' bank, offering a wide variety of payments services. It distributes currency and coin, processes checks and offers electronic forms of payment. The Fed competes with the private sector in its financial services to foster competition in the marketplace, and promote innovation and efficiency in the payments system. It does not seek to make a profit from its participation; it sets prices only to recover costs.

TRADITIONAL FORMS OF PAYMENT

Regional Reserve Banks are responsible for meeting public demand for currency and coin within their districts. The Reserve Banks' primary responsibility in providing this service is to ensure that fluctuations in the demand for currency and coin do not disrupt the banking industry. Vaults at Reserve Banks process and store currency and coins for financial institutions.

In addition to providing currency and coin, Reserve Banks also process commercial checks. Every day, for example, the St. Louis Fed processes approximately 1 million commercial checks. At a regional Reserve Bank the process of receiving, processing and dispatching checks goes on 24 hours a day.

Regional Reserve Banks work continually to improve the payments system by introducing new services and enhancing old ones. The Fed is leading the industry's push to replace paper forms of payment like checks with electronic forms of payment, which offer lower risk and higher efficiency to the payments system.

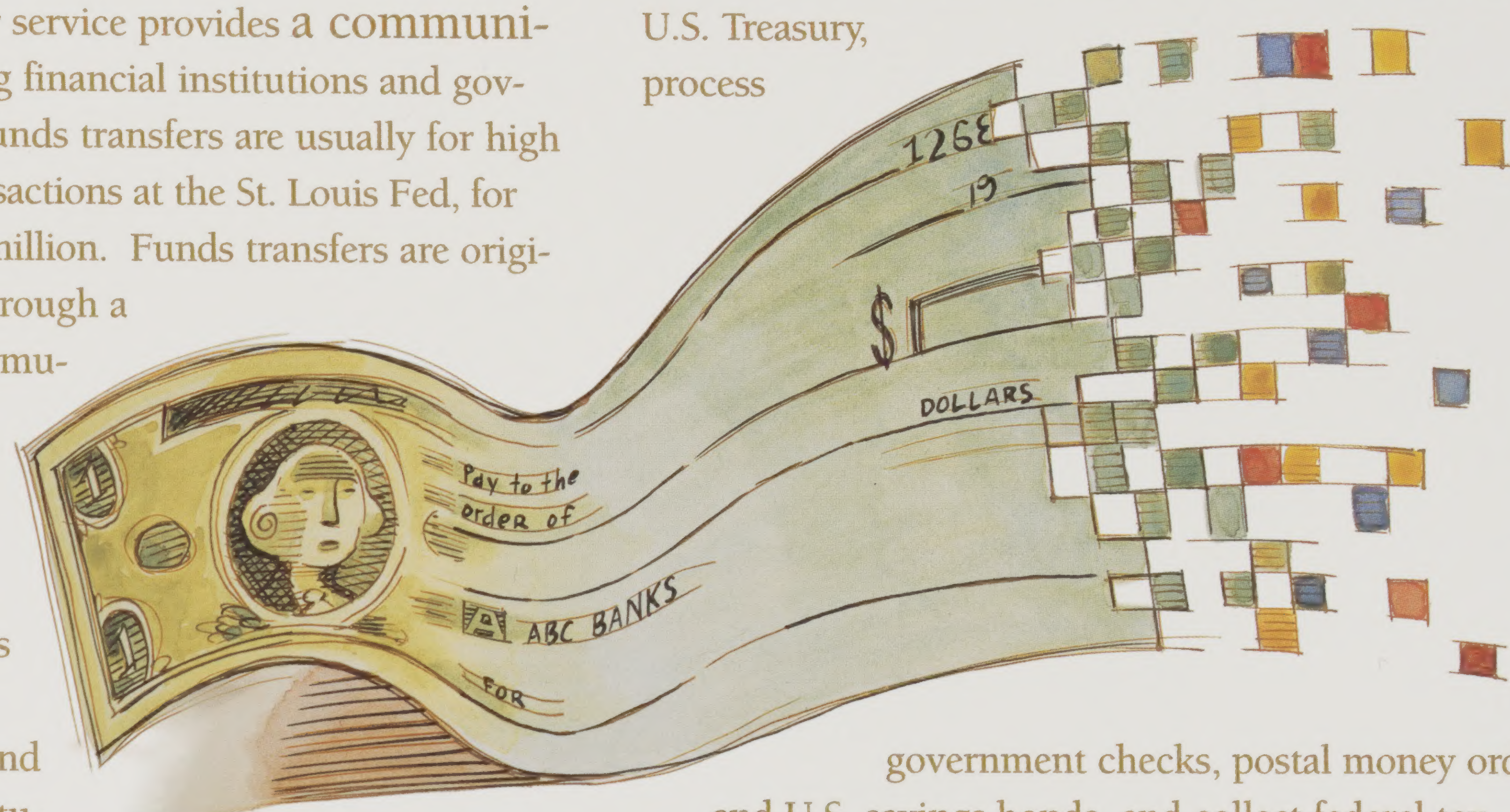
In keeping with its mission to evolve toward electronic payments, the Fed has developed several electronic initiatives in check processing. One of these—image technology—scans checks as they pass through high-speed sorting equipment and captures their images in

electronic form for processing. Another initiative—electronic check presentment—also processes an electronic file, increasing the speed of check collection and reducing the costs of transporting paper.

ELECTRONIC FORMS OF PAYMENTS

Every day billions of dollars are transferred electronically among U.S. financial institutions. The Reserve Banks provide two electronic payment services: funds transfer and the automated clearing house, or ACH.

The funds transfer service provides a communications link among financial institutions and government agencies. Funds transfers are usually for high dollar amounts—transactions at the St. Louis Fed, for example, average $3 million. Funds transfers are originated and received through a sophisticated telecommunications network known as Fedwire, which links all Reserve Banks electronically. Institutions can move their balances at the Fed or send funds to another institution through this network.



The ACH provides a nationwide network to exchange paperless payments among financial institutions and government agencies. The ACH accommodates a wide range of recurring corporate and consumer transactions, such as payroll deposit, electronic bill payment, insurance payments and Social Security disbursements. ACH transactions are generally for much smaller dollar amounts than funds transfer transactions.

Meanwhile, other forms of electronic payment like smart cards, debit cards and paying on the Internet are making inroads. While the Fed does not directly provide theses services, it is involved in the development of universal standards to ensure safety, convenience and accessibility.

THE FED AS FISCAL AGENT

In addition to serving as the bankers' bank, the Federal Reserve System acts as banker for the U.S. government. Federal Reserve Banks maintain accounts for the U.S. Treasury, process government checks, postal money orders and U.S. savings bonds, and collect federal tax deposits. Reserve Banks also sell new Treasury securities, service outstanding issues and redeem maturing issues. When the Treasury offers new issues of marketable securities to the public, Reserve Banks disseminate information about the issues, process orders from customers, collect payments, credit the Treasury's account for the proceeds and deliver the securities. In recent years, the Fed has introduced electronic processing and delivery in many of these services.

What It All Means

A SUMMARY

For the past several pages, we have introduced you to who we are at the Federal Reserve—the Board of Governors, Reserve Banks and the FOMC—as well as what we do. We have also described our three main responsibilities—conducting monetary policy, supervising banks and providing payments services. We hope we have helped you make sense of the complex, yet effective function of the Federal Reserve System.

What becomes apparent is not only how important our functions are, but just how effective our structure is in fulfilling the purposes of the Federal Reserve System. It was a financial crisis that led to our creation, and a financial crisis is exactly what the Federal Reserve is best prepared to handle. Should a financial crisis arise in any part of the country, a Reserve Bank is close at hand with the banking and payments system expertise and emergency funds necessary to respond quickly.

Through the combined efforts of the Board of Governors, Reserve Banks and the FOMC, the Federal Reserve is in a strong position to make monetary policy, provide a safe banking system, contribute to an effective payments system, all of which contribute to a healthy economy.

To order additional copies of In Plain English, *call Public Affairs at the Federal Reserve Bank of St. Louis at (314) 444-8809.*

ADDITIONAL RESOURCES

ECONOMIC EDUCATION—ST. LOUIS FED
Economic Education Coordinator, St. Louis Fed, (314) 444-8421

PUBLICATIONS
A Day at the Fed. From the New York Fed, (212) 720-6134.

The Federal Reserve, Monetary Policy and the Economy. From the Dallas Fed, (214) 922-5254.

The Federal Reserve System In Brief. From the San Francisco Fed, (415) 974-2163.

The Federal Reserve System Purposes & Functions. From the Board of Governors, (202) 452-3244.

The Federal Reserve Today. From the Richmond Fed, (804) 697-8109.

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WEB SITES
St. Louis Fed: www.stls.frb.org
Board of Governors: www.federalreserve.gov
Public Information Catalog:
www.ny.frb.org/PICNIC/main.html

Can You Answer These In Plain English?

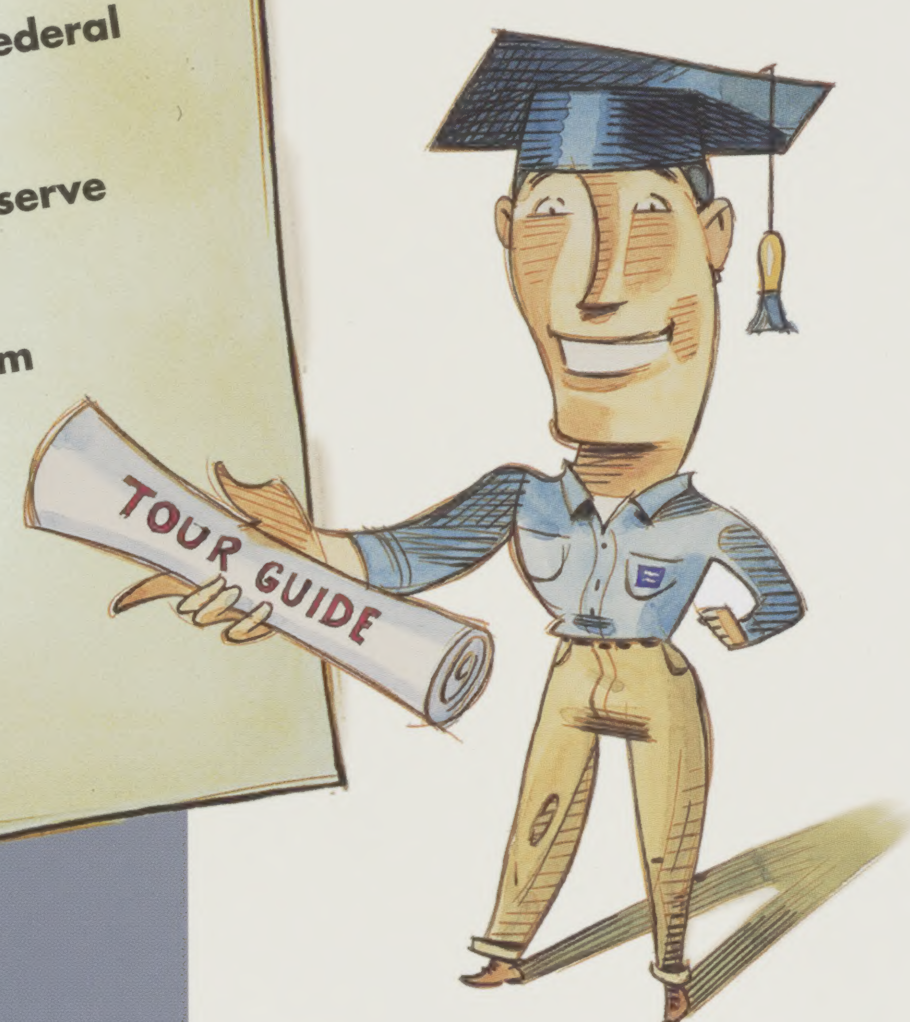
1. **Who created the Federal Reserve System? (page 1)**
2. **Name the three parts of the Federal Reserve System. (page 1)**
3. **Which part conducts monetary policy? (page 7)**
4. **Does the Federal Reserve set interest rates? (This one's tricky.) (page 7)**
5. **How many districts make up the Federal Reserve System? (page 9)**
6. **In which Federal Reserve District do you live? (pages 8-9)**
7. **What are the three responsibilities of the Federal Reserve System? (page 8)**
8. **Name three activities you might see at Reserve Banks. (pages 10-15)**
9. **How does banking supervision differ from banking regulation? (page 12)**
10. **Name three financial services the Fed offers. (pages 14-15)**

TESTING ONE, TWO

We hope you can now make sense of the Federal Reserve. So let's see if we've done our job by testing your newly acquired knowledge. If we stump you, refer to the page numbers in parentheses where you can turn for the answer.

Good luck!

Congrats, you made it!



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